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FISCAL IMPACT STATEMENT

LS 7130 | **DATE PREPARED:** Feb 25, 2002
BILL NUMBER: HB 1195 | **BILL AMENDED:** Feb 25, 2002

SUBJECT: Tax and Budget Matters.

FISCAL ANALYST: Bob Sigalow; Jim Landers
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FUNDS AFFECTED: X **GENERAL** | **IMPACT:** State & Local
X **DEDICATED**
FEDERAL

Summary of Legislation: (Amended) ***Mobile homes:*** This bill establishes the application filing period for certain property tax deductions and the homestead credit with respect to certain mobile homes and manufactured homes. It permits assessing officials to receive a per diem and a mileage allowance for attending training sessions before taking office.

South Bend Community Schools: The bill permits the board of trustees of the South Bend Community Schools to adopt a resolution returning to a calendar year budget cycle. It also provides that the resolution may be rescinded. It also updates population parameters to reflect changes in the 2000 decennial census.

Sales tax return*:* This bill specifies circumstances under which a sales tax return does not need to be filed each month.

Internal Revenue Code Update*:* It updates references in the law to the Internal Revenue Code to refer to the version of the Internal Revenue Code as amended through January 1, 2002.

***EDGE Credit*s:** The bill extends provisions relating to the economic development for a growing economy (EDGE) credit to persons that propose to retain existing jobs in Indiana.

Effective Date: (Amended) January 1, 2002 (retroactive); Upon passage; January 1, 2003.

Explanation of State Expenditures: (Revised) ***South Bend Schools*:** South Bend Community School Corporation (SBCS) became the fifth school with a budget based on the school year. The General Assembly established a pilot program and was scheduled to move all schools to a school year budget for the 2000-01 school year. SEA 508-2000 repealed the requirement of a school year budget, but allowed four of the pilot schools to retain the school year budgeting process. HEA 1096-2001 changed SBCS's budget year from a calendar year to a school year. The State Board of Tax Commissioners might need to meet with the South

Bend Community School Corporation to assist the school in changing from a school year budget back to the calendar year budget. The Tax Board would probably experience no additional expense associated with the change.

EDGE Credits: This bill may increase the amount of EDGE credits awarded annually as a greater number of businesses would be eligible for the credit. Under current statute, only job creation projects are eligible for EDGE credits and, then, only if the credit applicant can verify that another state is being considered for the project. The bill would extend EDGE credit eligibility to businesses considering projects that would retain existing jobs in Indiana. In addition, the bill would eliminate the requirement that another state is being considered for the project. Broader eligibility due to these provisions may expand the applicant pool, creating additional administrative demands on the Indiana Department of Commerce (IDOC) which provides administrative support to the EDGE Board. The IDOC should be able to meet these demands given its current budget and resources. The February 4, 2002, state staffing table indicates that the IDOC has 18 vacant positions.

Under current statute, the State Budget Agency (SBA) is also required to certify that EDGE credit awards will provide an overall positive fiscal impact to the state. An expanded applicant pool may increase the number of EDGE studies performed by the SBA, however, the impact is not expected to be significant.

Explanation of State Revenues: (Revised) ***Sales Tax Filing Periods****:* The bill restores statutory language that was deleted under P.L. 185-2001 affecting the frequency in which retailers with a relatively small tax liability must file with the Department of State Revenue. Under current law, as amended by P.L. 185-2001, retailers with a monthly Sales Tax liability between $25 and $75 are required to remit Sales Tax collections monthly. This bill restores language that allows these retailers to instead file quarterly.

Depending on the action of the DOR in conforming their Sales Tax collection requirements and procedures to P.L. 185-2001, this bill *could* cause a one-time forward shift in state Sales Tax collections. However, if the Department has still not conformed to P.L. 185-2001 by the date of this bill's passage, the provision will not have an impact on Sales Tax collections.

Internal Revenue Code Update: This bill updates the reference to the Internal Revenue Code to incorporate all the federal changes made up to January 1, 2002. The Economic Growth and Tax Relief Reconciliation Act of 2001 (HR 1836) made a number of federal tax changes that could affect Indiana state tax revenue. Many of those provisions will impact on state revenue due to changes in Indiana adjusted gross income (AGI) and the Federal Estate Tax.

Provisions which impact Indiana Adjusted Gross Income:

Education IRAs: HR 1836 made a number of changes to the Education IRA laws which are summarized below.

New Contribution Limits- The annual contribution limit is increased from $500 to $2,000. Contributions can be made for special needs beneficiaries after the beneficiary turns 18. Contributions may also be made from corporations, tax-exempt organizations, or other entities. The deadline for making contributions has been extended to April 15 of the following year, instead of December 31st of the tax year.

Higher Adjusted Gross Income Ceiling- The current income limit is increased from $150,000-$160,000 to $190,000-$220,000 for married taxpayers filing a joint return. (The phaseout range for single taxpayers remained at $95,000 - $110,000.)

Grades K-12 Expenses- Qualified expenses are expanded to include elementary and secondary school tuition, tutoring, computer equipment, room and board, uniforms, and extended day program costs.

Qualified Tuition Plans (QTP): HR 1836 allows private postsecondary institutions to establish qualified tuition programs after 2001. Distributions from state-sponsored qualified tuition programs will be exempt if made after 2001. Distributions from non-state programs will be exempt after 2003. Distributions from qualified tuition programs can be rolled over for the benefit of the same beneficiary after 2001. HR 1836 also allows a taxpayer to exclude QTP distributions from gross income and claim the HOPE or Lifetime Learning Credit as long as they are not used for the same expenses.

Employer-Provided Assistance: HR 1836 permanently extended this exclusion from adjusted gross income and expanded it to include graduate level courses after 2001.

Qualified Higher Education Expenses: Beginning in 2002, a taxpayer will be eligible for an "above-the-line" deduction for qualified higher education expenses. This deduction will sunset after 2005. This deduction may not be used in the same year as the HOPE or Lifetime Learning Credit for the same student. The amount of the deduction and income limits are outlined in the table below.

Tax Years Beginning	Modified AGI Limits	Amount of Deduction
2002 & 2003	Not more than $65,000 - Single Filers	$3,000
	Not more than $130,000 - Joint Filers	
2004 & 2005	Not more than $65,000 - Single Filers	$4,000
	Not more than $130,000 - Joint Filers	
	$65,000 to not more than $80,000 - Single	$2,000
	$130,000 to not more than $160,000 - Joint	

Student Loan Deduction: The income thresholds are raised to $50,000 - $65,000 for singles and $100,000 - $130,000 for joint filers. HR 1836 also repealed the first 60-month limit for which the deduction may be taken on interest payments along with the restriction that voluntary payments of interest are not deductible.

Tax-Exempt Bond Financing: HR 1836 expands the private activities for which tax-exempt bonds may be issued, to include elementary and secondary public school facilities which are owned by private, for-profit corporations under a public-private partnership with a state or local educational agency. These bonds are subject to a separate per-state volume limit equal to the lesser of $10 per resident or $5 M.

Pension and Retirement Savings Provisions: HR 1836 included numerous changes to the tax status of pension and retirement savings mechanisms. This act includes expanding retirement savings incentives along with reforming the current structure of qualified plans. Below is a summary of a few of these changes.

Contribution Limits of Individual Retirement Accounts (IRAs) & Roth IRAs- The amount an individual is allowed to contribute is increased for both the traditional IRA and Roth IRA as outlined below.

Tax Year	Contribution Limit
2001	2,000
2002 - 2004	3,000
2005 - 2007	4,000
2008	5,000
2009 & after	indexed for inflation

Catch-up Contributions- Taxpayers who are 50 and over will be able to make additional contributions to the various retirement savings plans as outlined below. After 2006, the IRS will adjust these amounts by a COLA.

Tax Year	401(k)/ 403(b) / SEP / 457 Plans	SIMPLE	IRAs
2002	$1,000	$500	$500
2003	$2,000	$1,000	$500
2004	$3,000	$1,500	$500
2005	$4,000	$2,000	$500
2006 & after	$5,000	$2,500	$1,000

Defined Benefit Plans- HR 1836 increased the annual benefit limit under a defined benefit plan to $160,000 (currently $140,000). The annual benefit limit will be reduced for benefits beginning before the age of 62, instead of 65, and will increase benefits beginning after the age of 65.

Defined Contribution Plans- The annual additions limit for defined contribution plans is increased to $40,000 (currently $30,000). (Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer.)

Compensation Limit- The annual compensation of each participant that could be taken into account for purposes of (1) determining contributions and benefits, (2) applying deduction rules, and (3) nondiscrimination testing was limited to $170,000. HR 1836 increased qualified plans' compensation limits to $200,000 and will be indexed for COLAs in $5,000 increments.

Elective Deferral Limits- The limits on the amount of elective deferrals to 401(k), 403(b) annuities, SEPs, SIMPLE, and Section 457 plans are increased by the following amounts.

Tax Year	401(k)/403(b)/SEPs	SIMPLE Plans	Section 457 Plans
2002	$11,000	$7,000	$11,000
2003	$12,000	$8,000	$12,000
2004	$13,000	$9,000	$13,000
2005	14,000	$10,000	$14,000
2006 & after	15,000	$10,000	$15,000

Estate Tax Impact: The Indiana Estate Tax will be phased out in concert with the elimination of the federal Estate Tax under the federal *Economic Growth and Tax Relief Act of 2001*. The federal Generation Skipping Transfer Tax is also repealed in 2010 under the federal *Economic Growth and Tax Relief Act of 2001*. Like the Estate Tax, the Indiana Generation Skipping Transfer Tax is also linked to the federal version of the tax. Thus, the federal repeal will result in the elimination of the Indiana Generation Skipping Transfer Tax with the update to the Internal Revenue Code references to January 1, 2002. According to the Indiana Department of State Revenue, the Generation Skipping Transfer Tax has brought in very little revenue.

Revenue from the Indiana Estate Tax likely will begin to decline in FY 2003. This decline is expected to continue until FY 2007 when the flow of revenue from the tax will likely cease altogether. The revenue decline beginning in FY 2003 will result from the phaseout of the state death tax credit and the accelerated increase in the unified credit under the federal Estate Tax. Ultimately, the revenue loss from the elimination of the Indiana Estate Tax is estimated at approximately $21.2 M. The *incremental* revenue loss each year as a result of the phaseout period is presented in the table below. The revenue loss totals are net amounts based on the difference in expected revenue given changes scheduled under prior federal law and expected revenue given the new federal Estate Tax law.

Year of Revenue Impact	Expected Indiana Estate Tax Revenue	Revenue Loss
FY 2003	$17.4 M	($7.4 M)
FY 2004	$7.0 M	($17.6 M)
FY 2005	$2.7 M	($21.0 M)
FY 2006	$735,000	($21.5 M)
FY 2007	$0	($21.4 M)
FY 2008	$0	($21.2 M)

It is important to note that the provisions of the federal legislation repealing the federal Estate Tax are scheduled to sunset at the end of 2010. The impact of the potential sunset of the Estate Tax repeal is not known. However, the Congress is expected to either extend the repeal provisions or make them permanent at some point prior to the sunset date.

Background:

Indiana Estate Tax: The Indiana Estate Tax is a "pick-up" tax that is imposed separately from the Indiana Inheritance Tax. The Estate Tax liability is based on the amount of Inheritance Tax paid by transferees of the estate and the credit that an estate is allowed to claim under the federal Estate Tax for death taxes paid to the state. For purposes of the federal state death tax credit, "death taxes" can be either estate taxes or inheritance taxes imposed by the state. The Indiana Estate Tax is equal to the amount by which the estate's allowable death tax credit exceeds the total amount of Indiana Inheritance Tax paid by transferees of the estate. Recent revenue totals for the tax are presented in the table below.

Fiscal Year	Indiana Estate Tax Revenue
1999	$24.7 M
2000	$21.0 M
2001	$28.9 M
3-Year Average	$24.9 M

State Death Tax Credit: The federal Estate Tax allows a credit for state death taxes paid in relation to an estate, whether these are estate or inheritance taxes. The allowable state death tax credit is computed from a credit table based on the adjusted taxable value of the decedent's estate, where the adjusted taxable value is the taxable estate value reduced by $60,000.

Impact of the Unified Credit on the Death Tax Credit: The state death tax credit can not exceed the federal estate tax liability after subtraction of the unified credit. The unified credit is taken by federal Estate Tax filers against the Estate Tax liability. The credit effectively exempts a portion of the gross value of any estate from taxation. For estates of decedent's who died in 2001, the unified credit (=$220,550) effectively shelters $675,000 in gross estate value from tax. Therefore, estates of 2001 decedents with a gross value of $675,000 or less would have a federal Estate Tax liability equal to zero. Thus, the state death tax credit is also equal to zero and no Indiana Estate Tax is owed.

<u>Federal Estate Tax Changes:</u>

The Economic Growth and Tax Relief Act of 2001 repeals the federal Estate Tax in 2010. However, two provisions of this legislation will impact the Indiana Estate Tax prior to that time.

(1) The federal legislation phases out the state death tax credit from 2002 to 2005. Under the phaseout, 2001 allowable credit amounts are reduced by 25% in 2002, by 50% in 2003, and by 75% in 2004. The credit is repealed in 2005 and replaced by a deduction from the gross estate value for death taxes actually paid to the state with respect to property included in the gross estate of the decedent. Since the Indiana Estate Tax is a computation utilizing the value of the state death tax credit, reductions in the allowable federal credit amounts will impact revenues from the tax. The repeal of the credit will effectively make the Indiana Estate Tax inoperative for estates of decedents who die in 2005 and subsequent years.

(2) The federal legislation also accelerates the increase in the unified credit that was scheduled to take place under prior law. The applicable exemption value of the unified credit for estates of 2001 decedents is $675,000. Under prior law, the applicable exemption value of the unified credit was scheduled to increase to $700,000 in 2002 and 2003, to $850,000 in 2004, to $950,000 in 2005, and to $1.0 M in 2006 and subsequent years. Under the new federal legislation, the increase in the unified credit is accelerated such that

the applicable exemption value increases to $1.0 M in 2002 and 2003, and to $1.5 M in 2004 and 2005 when the state death tax credit is in the last phase of its elimination. The changes to the unified credit are expected to remove estates from the estate tax rolls that would have had a tax liability under prior unified credit levels. This should exacerbate the expected decline in Indiana Estate Tax revenue due to the phaseout of the state death tax credit.

Sunset of Tax Change Provisions. In order to comply with the Congressional Budget Act of 1974, the provisions of the *Economic Growth and Tax Relief Act of 2001* will sunset on December 31, 2010. The impact of this is unknown. However, Congressional observers expect that the provisions of the Act will be extended or made permanent at some point in the future. Reportedly, the House leadership has indicated that legislation to make the provisions of the Act permanent will be considered in the near future.

Estimation Method: Because the Indiana Estate Tax does not have to be paid until 12 months after the decedent's death, the impact of changes to the unified credit and phaseout of the state death tax credit likely will be delayed until FY 2003. Based on this timetable, the flow of revenue from the Indiana Estate Tax likely will cease in FY 2007.

The revenue impact for each year is the difference between estimated Estate Tax revenue under the old and new regimes. The impacts are derived through simulations utilizing an OFMA database of Estate Tax returns relating to decedents who died between July 1, 1997, and June 30, 2000. The database consists of 559 estates upon which Indiana Estate Tax was paid. In performing the simulations, returns are excluded when necessary to account for the different unified credit levels, and necessary adjustments are made to the database to account for changes in the state death tax credit. The revenue impacts are based on an estimate of Estate Tax revenue for FY 2003 derived from the Revenue Technical Committee’s updated FY 2003 Inheritance Tax forecast (as of November 14, 2001). The forecast total is $140 M, which includes revenue from the Indiana Estate Tax. Based on FY 2001 collections, about 17.7% of this total is derived from the Estate Tax. This suggests that Estate Tax revenue will total approximately $24.8 M in FY 2003. Percentage reductions in the Estate Tax liability in the database due to pertinent changes in the unified credit and state death tax credit are utilized to reduce the FY 2003 estimate accordingly. Estimated Estate Tax revenue under the old and new regime, and the net revenue loss, are presented in the table below.

Fiscal Year	**Estimated Revenue Under Prior Federal Law**	**Estimated Revenue Under Current Federal Law**	**Net Revenue Loss**
2003	$24.8 M	$17.4 M	($7.4 M)
2004	$24.6 M	$7.0 M	($17.6 M)
2005	$23.7 M	$2.7 M	($21.0 M)
2006	$22.2 M	$735,000	($21.5 M)
2007	$21.4 M	$0	($21.4 M)
2008	$21.2 M	$0	($21.2 M)

A summary of the revenue impact of the *Economic Growth and Tax Relief Reconciliation Act of 2001* (HR 1836) is outlined in the table below. This assumes that Indiana updates the Internal Revenue Code reference in IC 6-3-1-11 to January 1, 2002, to incorporate all the Internal Revenue Code changes made to date including those referenced above in HR 1836.

Provision (revenue impact in $M)	FY 2002	FY 2003	FY 2004	FY 2005
Education IRAs	(.50)	(1.07)	(1.44)	(1.77)
Qualified Tuition Plans	(.06)	(.15)	(.24)	(.34)
Employer-Provided Assistance	(1.28)	(2.21)	(2.48)	(2.62)
Qualified Higher Ed Expenses	(3.80)	(6.37)	(8.34)	(9.42)
Student Loan Deduction	(.42)	(.75)	(.85)	(.90)
Tax-Exempt Bond Financing	(.01)	(.05)	(.11)	(.18)
Pension & IRA Provisions	(2.14)	(5.37)	(7.51)	(9.97)
Net Impact of AGI Provisions	(8.21)	(15.97)	(20.97)	(25.2)
Estate Tax Revenue Provisions		(7.40)	(17.60)	(21.0)
Total Impact on State Revenue	(8.21)	(23.37)	(37.57)	(46.2)

EDGE Credits: The bill extends eligibility for EDGE credits to businesses that undertake projects to retain existing jobs in Indiana. Under current statute, the EDGE Program is designed to provide a revenue-neutral incentive for businesses to create new investment and jobs in Indiana. Businesses receive credits equal to the individual income taxes withheld for employees filling the newly created positions. Since revenue from these employees would not have been collected in the absence of the new development, the state does not incur a net loss by redistributing the incremental income tax revenue as tax credits to businesses. For job retention project no new revenue would be realized since no new jobs would be created. As a result, EDGE credits would be paid from existing revenues, resulting in a net loss to the state equal to the amount of EDGE credits granted to businesses for job retention. However, if a business were to select a more profitable alternative project site and move out of Indiana, there could be an even greater loss of revenue from the reduction in individual (employee's) and corporate taxes.

To be eligible for EDGE credits relating to a job retention project, a business must be involved in research and development, manufacturing, or provision of business services. In addition, the average compensation paid by the business during the previous fiscal year must be at least equal to the average compensation paid in the county in which the business is located. The business also must use the EDGE credits for investment in facility improvements or equipment and machinery upgrades, repairs, or retrofits; or for other direct business related investments, including training. A business receiving an EDGE credit for a job retention project must maintain operations at the project location for at least twice the number of years as the term of the tax credit. The actual amount of an EDGE credit for a job retention project would be established by the EDGE Board, and would presumably be based on the incremental income taxes withholdings attributable to the job retention project. However, the current limitation that EDGE credits not exceed the incremental withholdings only apply to job creation projects under the bill.

EDGE credits may be taken against a taxpayer's Gross Income Tax, Adjusted Gross Income Tax, Supplemental Net Income Tax, Bank Tax, Savings and Loan Association Tax, Insurance Premium Tax, or Financial Institutions Tax liabilities. The duration of the credit may not exceed ten taxable years. In 2000, the EDGE Board approved approximately $63 M in new credits (to be used over several years) for 16 projects. The projects are expected to create 6,382 new jobs with an annual payroll of approximately $308.8 M. From 1994 to 2000, EDGE credits have been approved for 72 projects. During those years, approximately $46.2 M in EDGE credits were made available, with the total amount of credits certified so far equal to about $25.1 M. Approximately $21.9 M in EDGE credits are available for approved projects in tax year 2001. Revenue from individual and corporate income taxes is distributed to the state General Fund. A percentage of corporate Adjusted Gross Income Tax revenue is also distributed to the Property Tax Replacement Fund. Since these provisions are effective upon passage, the changes may impact revenue collections beginning in FY 2003.

Explanation of Local Expenditures: (Revised) ***South Bend Schools*:** South Bend Community School Corporation may have some small expenses associated with changing from a school year to a calendar year budget.

***Assessor Training*:** Under current law, the DLGF must hold training sessions for new assessing officials, assessors, and members of county property tax assessment boards of appeals. New officials are entitled to receive a per diem payment and mileage allowance from the county when they attend a training session. This bill would allow the DLGF to approve a per diem and the county to approve a mileage allowance for a person who has been elected to an assessing office but has not yet taken office. Both the per diem and mileage allowance would be paid by the county. This provision would allow an official-elect to get paid for attending a training session. The fiscal impact would be minimal.

Explanation of Local Revenues: (Revised) ***Mobile Home Property Tax Deductions*:** Under HEA 1001 (2001), mobile home owners may receive most of the property tax deductions available to real property homeowners. Real property is assessed on March 1st with taxes payable in the following year. However, mobile homes are assessed on January 15th with taxes paid in the same year. This bill would adjust the deduction filing dates for mobile home owners so that they better fit the mobile home assessment cycle and to ensure that mobile home owners receive the deductions beginning in CY 2003.

State Agencies Affected: Department of State Revenue; Department of Local Government Finance (State Tax Board); Department of Commerce; EDGE Board.

Local Agencies Affected: Counties; Assessors; Auditors; South Bend Community School Corporation.

Information Sources: Jim Mundt, Department of State Revenue, 232-8022; Bill Reynolds, Indiana Department of Revenue, 232-2156; Joint Committee on Taxation, *"Summary of Provisions Contained in the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001."* May 26, 2001; OFMA Estate Tax database; Revenue Technical Committee Forecast, November 11, 2001; Joint Committee on Taxation; the Commerce Clearing House; the Research Institute of America, Inc.; and the Federal Tax Administrators; Indiana Department of Commerce, 2000 EDGE Annual Report, March 30, 2001.